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How Grandparents Can Help Grandchildren with College Costs

As the cost of a college education continues to climb, many grandparents are stepping in to help. This trend is expected to accelerate as baby boomers, many of whom went to college, become grandparents and start gifting what's predicted to be trillions of dollars over the coming decades.

Helping to pay for a grandchild's college education can bring great personal satisfaction and is a smart way for grandparents to pass on wealth without having to pay gift and estate taxes. So what are the best ways to accomplish this goal?

Outright cash gifts

A common way to help with college costs is to make an outright gift of cash or securities. But this method has drawbacks. If you gift the money directly to your grandchild, he or she might spend it on something other than college. Also, a gift of more than the annual federal gift tax exclusion amount--$13,000 for individual gifts, $26,000 for joint gifts--might have gift tax and generation-skipping transfer tax (GSTT) consequences (GSTT is an additional gift tax imposed on gifts made to someone who is more than one generation below you). Note that the $13,000 figure is for 2010. The exclusion is indexed for inflation, so this figure may increase in future years.

Another drawback to outright gifts is that a gift becomes an asset of the student, and the federal government treats student assets more harshly than parent assets for financial aid purposes. Students must contribute 20% of their assets each year toward college costs, compared to 5.6% for parent assets. Fortunately, there are better options available.

529 plans

A 529 plan can be an excellent way for grandparents to contribute to a grandchild's college education, while simultaneously paring down their own estate. Contributions to a 529 plan grow tax deferred, and withdrawals used for the beneficiary's qualified education expenses are completely tax free at the federal level (and at the state level too).

There are two types of 529 plans: college savings plans and prepaid tuition plans. College savings plans are individual investment-type accounts offered by nearly all states and managed by financial institutions. Funds can be used at any accredited college in the United States or abroad. Prepaid tuition plans allow prepayment of tuition at today's prices for the limited group of colleges--typically in-state public colleges--that participate in the plan.

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Grandparents can open a 529 account and name a grandchild as beneficiary (only one person can be listed as account owner, though), or they can contribute to an existing 529 account. Grandparents can contribute a lump sum to a grandchild's 529 account, or they can contribute smaller, regular amounts.

Regarding lump-sum gifts, a big advantage of 529 plans is that under special rules unique to 529 plans, individuals can make a lump-sum gift of up to $65,000 ($130,000 for joint gifts by married couples) and avoid federal gift tax. A special election must be made to treat the gift as if it were made in equal installments over a five-year period, and no additional gifts can be made to the beneficiary during this time.

Example: *Mr. and Mrs. Brady make a lump-sum contribution of $130,000 to their grandchild's 529 plan in Year 1, electing to treat the gift as if it were made over 5 years. The result is they are considered to have made annual gifts of $26,000 ($13,000 each) in Years 1 through 5 ($130,000 / 5 years). Because the amount gifted by each spouse is within the annual gift tax exclusion, the Bradys won't owe any gift tax (assuming they don't make any other gifts to their grandchild during the 5-year period). In Year 6, they can make another lump-sum contribution and repeat the process. In Year 11, they can do so again.*

Significantly, this money is considered removed from your estate, even though one grandparent can still retain control over the funds if he or she is the 529 account owner. There is a caveat, however. If the donor were to die during the five-year period, then a prorated portion of the contribution would be "recaptured" into the estate for estate tax purposes.

Example: *In the previous example, if Mr. Brady were to die in Year 2, his total Year 1 and 2 contributions ($26,000) would be excluded from his estate. But the remaining portion attributed*

to him in Years 3, 4, and 5 ($39,000) would be included in his estate. The contributions attributed to Mrs. Brady ($13,000 per year) would not be recaptured into the estate.

Another attractive feature of 529 plans is that under current law, grandparent-owned 529 accounts are excluded by the federal government's financial aid formula--only parent-owned 529 plans count. So a grandparent-owned 529 plan won't impact a grandchild's chances of qualifying for federal aid.

However, if you need the money in your 529 account for something other than the beneficiary's college expenses--for medical expenses or emergency purposes, for example--you'll face a double consequence: the earnings portion of the withdrawal is subject to a 10% penalty and will be taxed at your ordinary income tax rate.

Also, note that funds in a grandparent-owned 529 plan may still be factored in when determining Medicaid eligibility, unless these funds are specifically exempted by state law.

Note: *Investors should consider the investment objectives, risks, charges, and expenses associated with 529 plans before investing. More information about specific 529 plans is available in each issuer's official statement, which should be read carefully before investing. Also, before investing, consider whether your state offers a 529 plan that provides residents with favorable state tax benefits.*

Did you know...

- *If your grandchild doesn't go to college or gets a scholarship, you can name another grandchild as beneficiary with no penalty*
- *Many states offer income tax deductions for contributions to their 529 plan*
- *As of March 2009, there were over 11 million 529 plan accounts (Source: College Board's Trends in Student Aid 2009)*
- *A recent survey of grandparents revealed that over half were--or planned on--contributing to their grandchildren's college education (Source: Financial Research Corporation)*

Pay the college directly

Another excellent way for grandparents to help their grandchildren with college costs is to pay the college directly. Under federal law, tuition payments made directly to a college aren't considered taxable gifts, no matter how large the payment. So you don't have to worry about the $13,000 annual federal gift tax exclusion. But this is true only for tuition--room and board, books, fees, equipment, and other similar expenses don't qualify. Aside from the obvious tax advantage, paying tuition directly to the college ensures that your money will be used for education, plus it removes the money from your estate. And you are still free to give your grandchild a separate tax-free gift each year up to the $13,000 limit.

However, colleges will often reduce a student's financial aid by the amount of the grandparent's payment. Before sending a check, ask the school how it will affect your grandchild's eligibility for school-based aid. If your contribution will adversely affect your grandchild's financial aid package, another option is to give the money to your grandchild after graduation to help him or her pay off student loans.

Private elementary/secondary school

Finally, if you're interested in contributing to your grandchild's private elementary or secondary school education, a Coverdell education savings account (ESA) can help. Up to $2,000 per beneficiary can be contributed to a Coverdell ESA each year. Like funds in a 529 plan, the money grows tax deferred and is tax free at both the federal and state levels if used to pay the beneficiary's qualified education expenses, including private elementary and secondary school as well as college. But there are income limitations on who can contribute to an ESA. Specifically, married couples with a modified adjusted gross income over $220,000 ($110,000 for individuals) can't contribute.

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